



Statement before the Senate Committee on Foreign Relations

# U.S.-India Relations: Balancing Progress and Managing Expectations

Sadanand Dhume  
Resident Fellow  
American Enterprise Institute

Tuesday, May 24, 2016

*The American Enterprise Institute for Public Policy Research (AEI) is a nonpartisan, nonprofit, 501(c)(3) educational organization and does not take institutional positions on any issues. The views expressed in this testimony are those of the author.*

Chairman Corker, Ranking Member Cardin, members of the committee, thank you for this opportunity to testify before the committee on “U.S.-India Relations: Balancing Progress and Managing Expectations.” I am Sadanand Dhume, a resident fellow at the American Enterprise Institute, a non-profit, non-partisan public policy research organization based in Washington, DC. My comments today are my own and do not necessarily reflect the views of AEI.

Over the past two decades, both Democratic and Republican administrations have pursued closer relations with India. A strong bipartisan consensus in Congress has boosted this effort to build ties with the world’s most populous democracy. At a time of great flux in Asia, India occupies a pivotal place in the region, wedged between a rapidly rising China and the turmoil of Afghanistan and Pakistan. U.S. hopes of fostering peace and prosperity in Asia—and of preventing any single power from dominating this region—rest in no small measure on deepening the U.S.-India relationship and supporting ongoing Indian efforts at economic and military modernization.

Prime Minister Narendra Modi’s visit to Washington next month, when he will become the first foreign leader to address a joint session of Congress in 2016, underscores the importance both countries attach to this relationship. This will be Mr. Modi’s second bilateral visit to Washington in less than two years, and his fourth to the U.S. since he took office two years ago. Mr. Modi and President Obama have met seven times in the last two years. This sustained high level engagement, culminating in next month’s visit, presents an opportunity to cement progress made over the past few years and set a platform for the next administration to build upon.

Despite occasional hiccups, U.S.-India ties have witnessed a steady upward trajectory since the late 1990s. India conducts more military exercises with the U.S. than with any other country. Over the past 10 years, total U.S. defense sales to India have grown from \$300 million to approximately \$14 billion. India now has 10 heavy lift C-17s, the largest fleet outside the U.S.

Military exercises are also growing in complexity. Last year, Japan joined the U.S.-India Malabar naval exercises as a permanent member. Since 2012, India has also participated in PACOM’s Rim of the Pacific Exercise (RIMPAC), the world’s largest international maritime warfare exercise. Thanks in large part to the efforts of Defense Secretary Ashton Carter, the Defense Technology and Trade initiative also shows promise as the two countries move toward co-production and co-development on six projects spanning protective clothing for soldiers to aircraft carriers.

In fighting terrorism, too, the U.S. and India face common challenges. But as pluralistic societies they also share experiences of managing the threat. Although it houses the second largest Muslim population in the world, India shows relatively few signs of homegrown radicalization. Barely a few dozen Indian Muslims have signed up to fight for the Islamic State, compared with several thousand from Western Europe.

Economic relations have deepened too, albeit from a modest base. Between 2002 and 2015, bilateral trade in goods and services quintupled from \$21 billion to \$107 billion. Since 2004, U.S. FDI stock in India has more than tripled from \$8 billion to \$28 billion. According to the Confederation of Indian Industry, 100 Indian companies have invested \$15 billion in 35 U.S. states, creating 91,000 jobs. Indian students add \$3.6 billion to the U.S. economy each year. At the same time, the three-million-strong Indian-American population continues to act as a bridge between the two countries.

Nonetheless, neither country should take this continued progress for granted. For one, recent gains notwithstanding, trade ties remain far below potential. With an annual output of \$2.1 trillion, India is the seventh largest economy in the world. In purchasing power parity terms it is even larger—a \$8 trillion economy, or the world’s third largest. Yet, in 2015, with trade in goods of \$66.7 billion, India was only the U.S.’s tenth largest trading partner in goods, ranked below smaller economies such as Taiwan and South Korea. Without a deeper trade relationship, and an India more deeply integrated into the global economy, the relationship risks remaining unsustainably lopsided toward shared geopolitical and security concerns.

The U.S. should also recognize that India’s history and domestic politics preclude it from becoming a formal U.S. ally such as Japan or South Korea. Keeping expectations sober will ensure that ties remain on even keel rather than careening between unrealistic ambition and ensuing disappointment. At its heart, the U.S. bet on India represents the hope that a large democratic, pluralistic country, rooted in common law traditions, and home to an English-speaking elite, will succeed in Asia. At the same time, however, U.S. interest in India’s future carries implicit expectations: of economic reforms and a continued adherence to democratic values including pluralism, freedom of speech and human rights.

In the absence of a formal alliance, the robustness of India’s economy, strength of its military and quality of its democracy naturally become proxies for the health of the U.S.-India relationship, and the amount of policy attention New Delhi can sustainably attract from Washington. For this relationship to fulfill its potential, the U.S. ought to continue to take the long view, as it has during much of the past two decades, by playing a part in helping India fulfill its own aspirations. At the same time, India must recognize that the sustainability of U.S. commitment to its rise rests in large part on the success of the so-called “India model.” This will require not just continued strategic engagement with the U.S., but also continued reforms to make India a more competitive economy.

**Key policy recommendations:**

\*Asia-Pacific Economic Cooperation: Back India for full membership in APEC as a step toward eventual inclusion in the Trans-Pacific Partnership.

\*Seize new economic opportunities: The Modi government’s landmark economic initiatives in digital technology, renewable energy and urban infrastructure provide opportunities for U.S. firms to boost trade and deepen economic ties with India.

\*Enhance technology sharing: Make technology-sharing processes with India easier in order to assist its ongoing military modernization.

\*Champion sound economic principles: Instead of focusing solely on specific firms or areas of the economy, the U.S. should broadly support the principles of free enterprise that will allow India to unlock its economic potential.

### **Background:**

*Economic policy: India's tryst with socialism*

India bears the harmful legacy of past mistakes that have not been fully acknowledged, and therefore not fully repudiated. India's first prime minister, Jawaharlal Nehru, was a Fabian socialist who was contemptuous of markets, mistrustful of trade and enamored of state planning.

Nehru's daughter, Indira Gandhi turned the crude license-permit system she inherited from her father into a refined instrument of economic torture. In her time, the marginal tax rate rose to 97 percent and, thanks to the infamous license-permit raj even the most routine economic decisions, such as where to build a factory or how much it could produce, were made by bureaucrats. These policies, no more successful in India than anywhere else, guaranteed decades of stagnation and inspired the disparaging economic moniker, "Hindu rate of growth."

Between them, Nehru and Gandhi ruled India for all but four of its first 37 years of independence. They created a political discourse on the economy centered on government intervention that has not been fully overcome to this day.

Between independence in 1947 and the advent of economic reforms in 1991, India was one of Asia's worst performing economies. In the first three decades after independence (1947-77), despite a low base, the Indian economy grew at an anemic annual average of 3.5 percent. In 1964, the average Indian was about three-fourths as rich as the average South Korean. By 1984, the average South Korean was four times richer than the average Indian.

Only in 1991, faced with a balance-of-payments crisis, did India embark upon economic reforms. Then prime minister P. V. Narasimha Rao proceeded to scrap most licensing programs, reduce tariffs, and open the door to foreign investment. Almost as if on cue, growth rates, exports, and foreign-exchange reserves began to rise, and India joined a larger club of fast-growing Asian economies.

Since then, India's reform program has deepened, albeit in fits and starts. A new telecom policy led to India's mobile phone revolution. India currently has one billion mobile phone subscribers, the second highest number in the world. Competitive private firms have changed the face of Indian telecoms and aviation, and have made inroads in banking.

Between 1991 and 2014, the Indian economy grew on average at 6.6 percent per year. However, the reform process lost steam after 2004, when a left-of-center government took power. Though the economy continued to grow—buoyed by healthy global conditions and reforms unfurled before 2004—ultimately the lack of fresh reforms caught up with India. According to the World

Bank, growth fell from a high of 10.3 percent in 2010 to 5.1 percent in 2012. By the end of 2013, with the stock market falling and the rupee hitting historic lows against the dollar, India had come to be seen as one of the world's "fragile five" economies.

Though India's economy is large in absolute terms, it has failed to live up to its potential. Per capita income of \$5,700 (in PPP terms) is less than half that of China, though both countries had similar levels of per capita income barely 35 years ago. With a median age of 27, India is one of the youngest large countries in the world. In order to provide jobs to the 12 million people who enter the workforce each year, New Delhi will have to significantly deepen an economic reform program first embarked upon 25 years ago, but that has lost steam over much of the past decade.

Currently, the IMF regards India as "a bright spot" in the global economy. But today's generation of reformers faces essentially the same challenges as its predecessors: to complete India's transformation from a state-dominated economy to a market-oriented economy.

### *Foreign Policy: The legacy of non-alignment*

Through most of the Cold War, U.S.-India ties were frosty. Indeed, India largely took a parallel approach to economics and international politics. Nehru spearheaded the non-aligned movement (NAM): an alliance of third-world countries whose aim—as the 1979 Havana Declaration would later summarize—was to protect "the national independence, sovereignty, territorial integrity, and security" of its members in their joint "struggle against imperialism, colonialism, neo-colonialism, racism, Zionism, and all forms of foreign aggression, occupation, domination, interference, or hegemony, as well as against great-power and bloc politics."

In theory, the NAM was intended to keep New Delhi independent of both Moscow and Washington. In practice, beginning with India's failure to condemn the Soviet Union's 1956 invasion of Hungary, both the movement's worldview and its rhetoric tilted conspicuously toward the Kremlin. This, along with the stark Dullesian division of the world into friend or foe, helps explain the frigid state of U.S.-India relations for many years, and the contrasting warmth of the U.S. embrace of a pliant Pakistan.

Though the nonaligned movement still exists in theory, in practice the end of the Cold War, and the emergence of the U.S. as the sole superpower, ended its relevance. Changes in attitudes toward the West have accompanied the opening of India's economy. Patient diplomacy and family ties forged by immigration have also played a part. Today Indians are among the most pro-American people in Asia. A Pew Research Center survey of "global attitudes" last year found that seven in ten Indians hold a favorable view of the United States.

Like their counterparts in the U.S., most major Indian political parties share a broad consensus on the importance of deeper ties with Washington. Since the end of the Cold War, both the ruling right-of-center Bharatiya Janata Party and the opposition Congress Party have recognized the central role the U.S. will play in India's modernization. Nonetheless, of the two major parties, the BJP has traditionally felt less constrained by the legacy of nonalignment. This gives it greater room to pursue rapid strategic convergence with the U.S.

## **The rise of Narendra Modi**

After a period of pronounced drift in India between 2011-14, the election of Mr. Modi as prime minister in 2014, with the first single party electoral majority in 30 years, raised hopes that New Delhi would return emphatically to the path of greater global engagement as well as structural economic reform. Despite a few mishaps, Mr. Modi's foreign policy is widely regarded as astute and imaginative. On his watch, India's relations with the U.S., Japan and Israel have thrived, as they have with important neighbors such as Sri Lanka and Bangladesh. The prime minister has rightly made the U.S. the centerpiece of his foreign policy, though, as with past Indian leaders, this has not meant forswearing the pursuit of better ties with other important powers.

However, on the economy, the single biggest determinant of India's trajectory, Mr. Modi's record is mixed. On the campaign trail two years ago, Mr. Modi painted his vision for the economy through slogans such as: "minimum government, maximum governance," "red carpet, not red tape," and "the government has no business being in business." His record as the dynamic and business-friendly chief minister (the Indian equivalent of governor) of the industrialized western state of Gujarat (2001-14) also raised hopes among investors and commentators that he would swiftly implement the kind of far-reaching reforms that had long been discussed, but had nonetheless eluded India over the past decade.

So far, the Modi government has proceeded cautiously on reforms, preferring what it calls "creative incrementalism" to so-called "big bang reforms."

On the positive side, the government has rolled out the proverbial red carpet for investors, with the prime minister himself acting as India's chief pitchman. Foreign investment caps have been eased in, among other areas, defense, insurance and food processing. According to the United Nations Conference on Trade and Development, \$59 billion of FDI poured into India in 2015, nearly twice as much as the year before. In the same period, pledged greenfield FDI—proposed investments in new assets rather than existing ones—in India was the highest in the world at \$63 billion. Several high profile firms including Taiwan's Foxconn and South Korea's Posco have pledged billions of dollars of fresh investment in India. Large U.S. investors include General Electric, General Motors, Uber and Oracle. India is trying to woo Apple to set up a manufacturing plant.

The IMF expects India's GDP to grow at 7.5 percent this year, which would make it the world's fastest growing major economy. The government also intends to boost infrastructure spending to \$32 billion dollars this year, a 22.5 percent increase from the previous year, in order to upgrade India's roads, ports and railways. Despite stepped-up government spending, Finance Minister Arun Jaitley expects to keep India's fiscal deficit in check at a reasonable 3.5 percent of GDP next year.

The government also hopes to end harassment by tax officials by simplifying rules. This is part of a larger effort to improve India's Ease of Doing Business ranking, which despite government efforts to improve it, is currently an unimpressive 130 of 189 countries surveyed by the World Bank. In May, the government passed a much-awaited bankruptcy law designed to make it easier for firms to shut down. This will likely further boost India's ease of doing business ranking.

However, in terms of deep structural reform, Mr. Modi has either been stymied by the opposition or has himself preferred caution to boldness. Thanks to opposition in the indirectly elected upper house of Parliament, a proposed goods and services tax to stitch India into a common market was not rolled out this April as planned. The opposition has also forced the government to retreat on a proposal to ease land-acquisition norms for industry.

Labor law reform—in effect making it easier for firms to lay off workers during a downturn—has been shunted to the states, but only a handful of them appear interested in pursuing them seriously. A proposed privatization program has stalled. Though the government says it remains committed to privatization, the prime minister has also suggested that he can stem the rot in state-owned companies, and a largely state-owned banking system, simply by picking the right managers. This has not worked in the past; there is no reason to believe that it will change.

Despite holding a comfortable majority in the lower house of Parliament, the Modi government has done nothing to reverse the previous government's worst laws, like an unpopular retroactive tax. Also in force is a government directive that goads companies to channel some of their profits toward social objectives such as reducing child mortality and combating AIDS. In reality, politicians use the provision to “encourage” businessmen to fund their favorite boondoggles.

Mr. Modi has undoubtedly stabilized the economy and perked foreign investor interest. But the jury is still out on his ability to launch India on a path of sustained high growth. The measures he enacts over the remaining three years of his term will determine whether his contribution to the economy will extend beyond better administration to the deeper reforms India needs.

### **What the U.S. can do:**

**Asia-Pacific Economic Cooperation:** *Back India for full membership in APEC as a step toward eventual inclusion in the Trans-Pacific Partnership.*

Founded in 1989, the 21-nation APEC is East Asia's broadest economic grouping and the world's largest trading bloc, accounting for three billion consumers and 44 percent of global trade. In 2010, a decade long moratorium on new members expired, opening the door for India, whose initial application for membership in 1991 was rejected.

The U.S. has welcomed India's interest in joining APEC, but has not backed formal membership. Publicly backing India's candidacy for APEC membership would echo a broad U.S. policy that supports India's rise as a responsible global power. Washington has already supported Indian membership in the G-20, four multilateral nonproliferation regimes, and an expanded United Nations Security Council. In addition, India is already a full member of the East Asian Summit and the ASEAN Regional Forum, and is a dialogue partner with ASEAN.

The case against backing India's entry into APEC hinges on its notoriously obstreperous trade negotiators, who some of their American counterparts hold responsible for helping create a stalemate at the World Trade Organization. They fear that admitting India into APEC will hurt the group's capacity for consensus building and dilute the quality of its trade agreements.

Although these concerns are legitimate, backing India's APEC membership is a low-risk gambit for the United States and carries potentially large rewards. At worst, India complicates the

workings of an already unwieldy body that concludes nonbinding agreements among members. At best, India uses APEC membership as training wheels to prepare it for the more ambitious Trans-Pacific Partnership (TPP), embraces the best practices APEC espouses, invigorates the grouping with new energy, and integrates itself more fully into the global economy.

**Seize new economic opportunities:** *The Modi government's landmark economic initiatives in digital technology, renewable energy and urban infrastructure provide opportunities for U.S. firms to boost trade and deepen economic ties with India.*

India's ongoing economic expansion, spurred by a government that has placed economic development at the heart of its program, opens up new opportunities for U.S. firms, and a chance to boost U.S.-India trade. The U.S. ought to continue efforts to emerge as a significant player—in terms of both business and technology—in Indian efforts to modernize urban infrastructure, enhance digital connectivity and boost the proportion of energy produced by renewable sources such as solar power.

According to the government, India will need to spend up to \$1 trillion over the next few years to upgrade its ports, roads and airports. As part of its “smart cities” project, India has already marked Ajmer in Rajasthan, Allahabad in Uttar Pradesh and Visakhapatnam in Andhra Pradesh as centers for U.S.-India collaboration. The U.S. Trade and Development Agency (USTDA) is involved in planning and providing technical assistance for these cities. A three-company consortium led by AECOM will implement a master plan for Visakhapatnam, the largest city in Andhra Pradesh.

The “Smart Cities” initiative reflects India's ongoing urbanization. Currently only about 32 percent of Indians live in cities, compared to 81 percent of Americans or 54 percent of Chinese. Similarly, Digital India and the Indian bid to build renewable energy capacity add up to a vision of the country's future: increasingly urbanized, networked, and (proportionally) less reliant on fossil fuel. An early U.S. involvement with these initiatives ought to go a long way toward strengthening the weakest link in bilateral relationship—comparatively weak trade ties.

According to the Telecom Regulatory Authority of India, the country currently has only 325 million Internet subscribers, or 25 percent of the population. The government expects this to rise to 38 percent of the population by the end of 2016. U.S. companies including Google, Facebook, Qualcomm and Microsoft will likely play a critical role in this ongoing modernization. Similarly, India hopes to install 100 Gigawatts of solar energy by 2022 at a cost of \$90 billion. If allowed to compete fairly, U.S. firms such as First Solar and SunPower ought to play a significant role in India's solar power expansion.

**Enhance technology sharing:** *Make technology-sharing processes with India easier in order to assist its ongoing military modernization.*



For decades following India's first nuclear tests in 1974, many Indian policy makers and strategic thinkers viewed U.S.-India relations through a thick web of technology denial spun in response by Washington. With the 2008 U.S.-India civil nuclear deal, as well as subsequent actions by the U.S. government, much of the technology denial regime once put in place to punish India for its nuclear explosions has receded. Nonetheless, both private Indian defense company executives and government officials say they find it easier to obtain high-end defense or dual use technology from Israel, France or Russia than from the United States.

The U.S. has already embarked upon technology sharing with India in multiple respects, most significantly through the Defense Technology and Trade Initiative. This includes six projects, including at least two, on jet engine technology and aircraft carrier technology that hold great promise. The Pentagon's creation of the India Rapid Reaction Cell, its first country-specific cell, should add further momentum in pushing the DTTI forward. If the U.S. and India can get DTTI to work it will automatically bring both countries' militaries closer in terms of interoperability, help India modernize its military more effectively, and ensure that the U.S. cements its place as India's most important defense partner.

**Champion sound economic principles:** *Instead of focusing solely on specific firms or areas of the economy, the U.S. should broadly support the principles of free enterprise that will allow India to unlock its economic potential.*

If economic relations between the U.S. and India are to avoid getting bogged down in minutiae, and are instead to serve U.S. strategic goals in Asia, the U.S. should encourage India to become a more competitive, market-oriented economy for its own sake, even if specific reforms offer no clear payoff for U.S. firms. For instance, India needs better roads, but given the lack of U.S. competitiveness in this area they are unlikely to be built by American firms, though they may at times be built with American equipment.

At the same time, the U.S. should aim to remain India's top trade partner. Last year, Secretary of State John Kerry reiterated the goal of multiplying U.S.-India trade fivefold, to \$500 billion, over ten years. But beyond just that number, the U.S. should also aim to stay ahead of China in volume of bilateral trade with India. This will likely spur more day-to-day attention to the relationship than a theoretical longer-term target would.

While consistently advocating for U.S. businesses, Washington should not allow individual companies to hijack the agenda. For instance, while India will undoubtedly benefit from opening up its retail market to Walmart and others, this is not necessarily the most pressing economic issue facing the country.

India needs to liberalize its labor and land markets, rationalize expensive food, fuel, and fertilizer subsidies, and privatize loss-making state-owned companies. Over time, as India's economy becomes bigger and more outward looking, many of these decisions will likely benefit U.S. companies. But they're important mostly because they will unleash India's own economy, raise the living standards of its people, and give it the wherewithal to fulfill the larger role it seeks on the world stage. Though the U.S. cannot make policy for India, it can certainly provide assistance to would-be Indian reformers who look to it for ideas and expertise.